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ABSTRACT

In 1992 the Clinton Administration proposed phasing out the federally guaranteed student loan program and replacing it with a direct lending program run entirely by the federal government, claiming that this approach would save taxpayer money and simplify a complex program. Opponents of the Administration plan argued instead for changes in federal laws so that budget targets set in 1994 would be met. Another approach, however, is suggested in this paper: setting up a competitive federal student loan system that would allow lenders to compete with the federal government in making new loans to students, and allow the federal government to compete with the private sector in buying up privately financed loans through secondary markets. At the end of a phase-in period, the final decision would be based on the experiences of both the federal government and direct lenders. Three additional ways to strengthen the Administration's proposal were also suggested: (1) using savings from reduced profits to cut the interest rate to borrowers and eliminate the insurance premium; (2) consolidating the number of federal student loan programs; and (3) restructuring guaranty agencies by making them agents of the federal government. An appendix examines whether direct government lending will save the federal government money. (DM)

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Association of Governing Boards
of Universities and Colleges

DIRECT LOANS: An Assessment of the Clinton Administration's Proposals and Some Suggestions for Improvement

By Arthur M. Hauptman

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Association of Governing Boards of Universities and Colleges
One Dupont Circle • Suite 400
Washington, D.C. 20036

Summary

The Clinton Administration has proposed a phase-in of direct loans that would totally replace the existing federally guaranteed student loan programs by the academic year 1997-98. The essence of the direct lending concept is to use federal funds rather than private funds as the source of capital for federal student loans.

Proponents of direct lending argue that it has two principal advantages over the current system. First, it could save federal taxpayers substantial sums of money. Second, direct lending has the potential for greatly simplifying what has become an excessively complex system for students and administrators alike.

Opponents of direct lending, including the many groups that profit from the current loan programs, have commissioned studies that say direct loans will not save the government money. None of these studies, however, makes a convincing case that direct lending will fail to save federal funds. The more legitimate concerns about direct lending revolve around the capacity of the federal government to centrally administer a program of this size.

Those who oppose direct lending have suggested instead that changes be made in federally guaranteed loans to reach the savings targets included in the 1994 Budget Resolution. They also suggest that the Direct Loan Demonstration created in 1992 be tested and evaluated before full-scale direct lending is implemented.

That groups which profit from the current programs are now lobbying to test direct lending through the demonstration, and are willing to accept cuts they previously rejected as impossible, is perhaps the most compelling argument for adhering to the Administration's framework for direct lending. If the perceived threat of direct lending is removed, however, by retreating to the demonstration as a pilot, then current program participants will be back in a year or two, arguing that the changes made in 1993 were too severe, and that more federal dollars are needed to ensure their continued participation in the federal student loan programs.

An alternative, which might better serve the needs of students and taxpayers alike, would be a competitive federal student loan system that would not rely entirely on the current guaranteed loan structure nor would it shift totally and irrevocably to the direct loan concept. Instead, these two financing systems would be tested and evaluated within a healthy competitive environment. The private sector would be able to compete with the government in the making of new loans, and the government could compete with existing secondary markets in buying up privately financed loans.

Under this competitive approach, the Administration's proposal would be phased in until direct loans accounted for half of new loan volume in 1996 and 1997. But unlike the Administration's proposal, profits also would be reduced for the millions of future federally guaranteed student loans that are privately financed.

The profit margins on privately financed loans could be reduced, first, by establishing an auction in which lenders would bid for the right to make new loans and, second, by adopting some of the proposals that have made by banks and others to cut federal payments and help ensure that these loans yield a true market-based rate of return in the future. The theory is that the current private sector participants would be willing to agree to these changes in return for the opportunity to compete with direct loans.

By the end of 1997, evaluations of both direct loans and the modified private system in terms of cost savings, simplification, and other criteria would be completed. In the next year, these evaluations would be debated and a decision then made on the future course of student loan policy. At that time, policy makers might decide to extend direct lending for all new loans, return to guaranteed loans if direct lending turns out to be a problem, or there might be some combination of the two financing systems. Whatever that decision is after several years of experience with both systems, the federal government then would be in a better position than it is now to decide which financing system to adopt.

Because the private sector is more likely to continue in the program under this competitive approach, it will be attractive to the many college officials worried about loan availability under direct lending. This approach also will allow the Department of Education to demonstrate its ability to manage a program of this size before making a total commitment to direct loans.

Introducing more competition into student loans would be akin to the military's practice of letting two or more contracts for building prototypes of major weapons systems, a practice that has proved more successful than depending on a single contractor. This kind of competition also seems more in keeping with the Clinton Administration's notion of reinventing government than do either the approach of having the federal government pay the private sector to do what is really a public function or having a highly centralized federal program that contracts for major services.

This report suggests some other ways to strengthen the Administration's proposal including the following:

o **Accelerate and enlarge the Administration's reduction in the costs to borrowers** by using the savings from reduced profits to cut the interest rate of borrowers by a full percentage point beginning in 1995 and eliminate the insurance premium that borrowers now pay.

o **Consolidate the number of federal student loan programs** rather than expand them as the Administration proposes to do.

o **Revamp the guaranty agency structure** regardless of whether the Administration's direct loan proposals are adopted, by reining in these entities to be agents of the federal government.

This report examines the Clinton Administration's direct lending proposals in the context of the many other proposals now being made for reforming student loans. It also suggests ways the Administration's direct loan proposals might be modified to achieve additional federal cost savings, further reductions in borrower costs, and greater program simplification -- three major objectives underlying the current debate on direct loans and student loan reform. This report does not address the many issues related to student loan repayments, including whether all student borrowers should repay on the basis of their income once they complete their education, and what role, if any, the Internal Revenue Service should play in student loans.

Some Principles to Guide Direct Loan Discussions

The debate in the Congress over direct loans will be marked by many conflicting constraints, demands, and estimates. The development of the Clinton Administration's direct loan proposals were governed by budgetary imperatives and a desire to address concerns about a loan system that has become increasingly complex and cumbersome. The many proposals now coming from the groups that profit from the current programs emanate from their interest in ensuring that adequate revenues and profits will continue to flow to them.

Colleges, and the associations that represent them, will focus on the need to maintain stability in the loan programs to ensure that students have adequate funds to attend the college of their choice. Student representatives will be intent on minimizing the cost of borrowing as well as maintaining the future adequacy of student aid funds in the form of both loans and grants.

To deal with these many conflicting interests and concerns, the following principles should govern the debate over direct loans and serve as a basis for discussion and negotiation about different proposals:

o The amount of savings targeted in the Fiscal 1994 Budget Resolution should be achieved through actual savings from direct loans as estimated through appropriate and reasonable methodologies. Any savings achieved through default reduction or the elimination of program eligibility for groups of students or institutions should not be considered as part of the debate over direct lending.

o The achievement of federal savings should not be accomplished through the imposition of additional charges to students or their families. Moreover, to the extent possible, any savings achieved above the levels called for in the budget resolution should be translated into reduced costs to current and future student loan borrowers.

o The development of a new federal student loan policy should minimize disruption in the provision of student loans to students. At the same time, the current student loan structure, which through a process of accretion over several decades has become excessively complex, should be streamlined.

o The new student loan structure also should build on the notion of reinventing government, by forming partnerships with states and the private sector that capitalize on the ability of those organizations to do what they do best. As a corollary, the federal government should not attempt to assume more responsibility for student loans than it can reasonably handle.

The Coming Explosion in Federal Student Loan Volume

Substantial increases in student loan volume are one of the little discussed consequences of the 1992 reauthorization of the Higher Education Act. With new loan limits and other changes contained in the reauthorization, annual loan volume will nearly double from what it was as recently as the late 1980s. About $100 billion in new loans -- on average $20 billion annually -- will be made in the five years beginning in the 1993-94 academic year. This growth in loan volume will further aggravate the much discussed but still largely unaddressed grant/loan imbalance.

This $100 billion in new borrowing over the next five years will be in addition to the roughly $70 billion in existing loans that are already in the pipeline, with the borrower either in school or in repayment. Thus, netting out repayments, there will be between $100 billion to $150 billion in outstanding federal student loans by 1998. This explosion in federal student loans is scheduled to occur regardless of whether the Administration's direct loan proposal is adopted.

The Administration's Direct Loan Proposal

The essence of the direct loan concept is to use federal funds rather than the traditional reliance on private funds as the source of capital for student loans. Direct loans promise two fundamental improvements in federal student loan policies. First, they could save federal taxpayers billions of dollars by reducing or eliminating the payments that are now made to banks and others that provide the capital and carry out the administrative functions of the program. And second, they could simplify what has become an excessively complex program for both administrators and students who borrow. This complexity has become a substantial barrier to improving access to postsecondary education.

Under the Clinton Administration's proposal, about $50 billion, or roughly half, of the $100 billion in new lending will be made directly with federal funds serving as the source of loan capital. Few direct loans would be made in fiscal 1994, while all

loans would use federal capital by fiscal 1998. The other half of new loans made over the next five years would continue to use private funds as the source of loan capital until the direct loan structure is fully in place.

Institutions, or consortia of institutions, that meet the Department of Education's criteria for being loan originators would be provided with access to federal capital to make loans to their students. But no institution would be required to be a direct lender. For students at institutions deemed incapable of being a direct loan originator, or that did not want the responsibility, alternative loan originators would be designated.

The Administration has proposed that those institutions or consortia of institutions that act as direct loan originators would receive a small fee of $10 per borrower to offset a portion of the marginal costs associated with the loan-origination function. Organizations that compete to be alternative loan originators would be compensated for what they bid as the full costs of loan origination.

Why Not Just Squeeze the Profits Out of the Current System?

For a number of years dating back to the late-1970s, the various organizations that profit from the federally guaranteed student loan programs have resisted proposed budget cuts in the program. While occasionally agreeing to modest changes in the existing program to meet budget cutting targets at the time, they maintained that there was no way to achieve large-scale savings within the current structure.

In this regard, 1993 has been remarkable in the annals of the federal student loan programs. Suddenly, cost-cutting proposals totalling several billion dollars over the next five years have been produced with stunning regularity by a variety of groups that previously argued that achieving such large-scale savings was impossible. It is clear that the cause for this shift in strategy was the realization that the Clinton Administration and the Congress were finally serious about achieving cost savings in the federal student loan programs.

Proponents for maintaining the current federally guaranteed loan system point justifiably with pride to its accomplishments. Many of them have suggested that the best path for the future is to squeeze excess profits from privately made guaranteed loans, while avoiding the hidden costs and the disruption that are likely to befall a system of direct lending. These proponents for guaranteed loans further argue that the demonstration program enacted as part of the 1992 reauthorization of the Higher Education Act should be tried, tested, and evaluated as a pilot before any further steps are taken in the direction of direct lending.

It will be very tempting for the policy makers in Congress to rely on proposals that trim the excesses in the current system in order to achieve the level of savings called for in the 1994 budget resolution, and to depend on the demonstration as the means for testing the concept of direct lending. Such a proposal is more likely to maintain the flow of loan capital to students, in contrast to the Administration's direct loan proposals which run the very real risk of substantial disruption of loan availability over the next five years if banks and others decide to withdraw before the full direct loan system is in place.

Trimming the current system also leaves in place the existing administrative structure without placing further stress on a federal bureaucracy that many believe is incapable of assuming the responsibilities called for in direct lending. Finally, it may be much easier for the Congress to trim the existing structure than to enact direct lending in the face of stiff opposition.

But Congress should resist the temptation of achieving the necessary savings simply by trimming the excess profits from the existing student loan structure for at least two reasons. First, the threat of direct loans is the reason so many student loan budget cutting proposals were produced this year. If Congress decides to squeeze the current program without establishing a viable direct loan alternative, the banks and others will come back in a year or two saying that they need additional compensation, that they misjudged how much cuts they could absorb. If a viable direct loan alternative is not then in place, the government will have no alternative but to accede to those demands, just as it has been forced to do in the past.

Second, only squeezing the profits out of the current system would preclude achieving many of the other benefits inherent in direct lending. For example, of the proposals on the table at this time to modify the existing structure, much of the savings would be achieved by asking borrowers to pay more in one form or another. The fact that student borrowers would not be asked to pay for any of the savings is one of the great virtues of the direct loans. Rather than have students pay more, direct loans would reduce federal costs by eliminating the most glaring inefficiency in the current system, namely, that the federal government pays far more for the use of private funds than it would cost if federal funds were the source of capital.

Squeezing the profits out of the current system also will not result in the degree of simplification and streamlining that direct loans have the potential to provide. Leaving the existing structure in place, albeit it at reduced profit and revenue levels, means that the vast array of lenders, guaranty agencies, secondary markets, and others will stay in place, making it very difficult to achieve the kind of simplification in the student loan delivery system that many people agree is so needed.

In response to the argument that the Direct Loan Demonstration Program should be allowed to operate for several years before direct lending is introduced on a much larger scale, the Administration's proposal for direct lending represents a sharp improvement over the demonstration program because:

- It sets forth criteria to judge whether institutions have the administrative and other capacities to serve as direct loan originators. The demonstration program presumed that all institutions would be eligible to serve as direct lenders.

- It establishes an alternative direct lending mechanism for students who attend institutions that are judged incapable of serving as direct lenders. This alternative also means that no institution will be required to be a direct lender. The demonstration program provides for no such alternative.

- It is free of many of the restrictions written into the legislative language of the Demonstration program at the request of those groups with a vested financial interest in seeing the demonstration fail. These restrictions include how many direct loans could be made and who could provide the loans.

The fact that those who profit from guaranteed student loans are now lobbying to test direct lending through the Demonstration, and are willing to accept cuts which previously they have rejected as not possible, is the most compelling argument for adhering to the Administration's framework for direct lending, rather than returning to reliance on the Demonstration as a pilot program.

The Dispute Over the Potential Federal Savings From Direct Loans

The issue that has dominated the legislative debate on direct lending thus far is whether the federal cost savings predicted for direct loans will, in fact, materialize. The Congressional Budget Office (CBO) and the General Accounting Office (GAO) have produced cost estimates that support the Clinton Administration's assertion that direct lending will save federal taxpayers substantial amounts of money -- more than $4 billion over the next five years.

It is important to understand that this debate over direct loans would not have occurred had it not been for passage of credit reform as part of the Budget Enforcement Act in 1990. Before credit reform, federal budget accounting procedures were biased in the direction of guaranteed loans. Only the initial-year costs of guaranteed loans appeared in the budget when the loan was made, whereas the capital for direct loans was counted as spending when the loan was made. Under credit reform, the accounting for direct and guaranteed loans were placed on a much more equal budgetary footing.

With credit reform, the basis for the savings from direct loans is rather straightforward. By using federal rather than private funds as the source of student loan capital, direct loans cost the federal government less than in the case of guaranteed loans where it pays private lenders for the use of their money.

The federal cost savings from direct lending occur at two points during the borrowing cycle. When borrowers are in school, the savings from direct lending result from the difference between what the government now pays lenders and the government's own cost of funds.

During the repayment period, what the government saves from direct lending is actually the "profit" it would make from the difference between what the borrower repays and the cost to the government of borrowing plus the cost of servicing the loans. These profits during repayment currently go into the pockets of the Student Loan Marketing Association (Sallie Mae) and other student loan holders. Combined, these two types of savings would cut the current federal costs of student loans roughly in half, with the largest remaining federal cost being losses from defaults.

A number of studies and reports dispute whether these savings will occur. (Appendix A examines whether direct loans save the federal government money, and review several of these studies.) The most frequently cited of these studies was conducted by the Congressional Research Service (CRS). Proponents for maintaining the status quo in student loans widely quote the CRS study because it is from a reputable government agency and because it argues that direct lending will not save the federal government any money.

But it also is the case that the basic conclusion of the CRS report corroborates the point made by proponents of direct lending, namely, that excess profits can be wrung out of the existing federal student loan programs. What the CRS report ignores is that in the absence of a serious direct lending proposal, groups with an interest in the status quo always have been successful in resisting efforts to squeeze the profits in the program.

Several studies recently have been commissioned or conducted by groups with a vested financial interest in maintaining the current programs. These studies have raised a number of questions about the potential savings from direct loans. The most legitimate of these questions is that the government's overall cost of capital could increase as a result of the additional borrowing needed to finance the loan capital used for direct lending. There is an ongoing argument among reputable economists, however, whether more government borrowing raises its cost of money; the experience in the 1980s would seem to suggest otherwise, as capital markets for public and private debt have became more similar over that time.

Moreover, the government will still need to borrow significant amounts to pay subsidies to the lenders of privately financed loans. A critical study of direct lending conducted by Rudolph Penner, former director of the Congressional Budget Office, in fact acknowledges that the cumulative amount the government would have to borrow to subsidize private lenders will exceed the amount of government borrowing needed to provide the capital for direct loans by the year 2004. Thus, even the critics of direct lending agree that the government's need to borrow within ten years of when direct loans begin will be less than it would be if the current program were to continue as it is. But this fact is not reflected in the cost estimates provided in the Penner and other studies.

The other contentions in these various studies mostly have to do with the additional administrative costs that could result from the adoption of direct lending and who will bear these costs. Sallie Mae, for example, has sent voluminous materials to college officials arguing that the administrative costs they will have to assume under the Administration's proposal will be enormous. This argument continues to be made despite the fact that the Administration's bill specifically provides that no institution will be required to be a direct lender.

Many of these assertions about the administrative costs under direct lending also defy common sense. If true, it would mean that there are no profits in the current program, which runs counter to the large effort being expended by these groups to maintain the status quo. Even a generous allowance for administrative costs makes only a small dent in the savings generated from having the federal government provide the funds directly. The reductions in savings would be much less than one-quarter of the total savings that come from using federal funds as the source of loan capital.

The More Legitimate Concerns About Direct Lending

While the questions about cost savings from direct lending tend to be self serving, there are a number of legitimate reasons for policy makers to worry about the Administration's decision to move to a direct lending program by 1997. For example, relying on federal funds to provide all of the capital for student loans is untested. This is of particular concern as the volume of federal student loans will grow rapidly over the next several years.

College officials' concerns about the Administration's direct lending proposals center on the importance of continued loan availability. A major disruption in the flow of federal student loan capital could wreak havoc on many hundreds of campuses across the country. College officials, among others, also worry about the federal government's capacity to run such a program, a concern that emanates from their previous dealings with the U.S. Department of Education, dealings which have been characterized by delays and inflexibility on the part of many government officials.

Nor have past efforts at a federally funded and centrally administered student loan program been all that auspicious. The Perkins loan program, which was the first federal direct loan, has worked fine for a number of colleges and universities. But many institutions no longer are eligible to receive new federal capital contributions in the Perkins program because they did not meet its acceptable repayment standards. The Federally Insured Student Loan program in the 1970s had exceptionally high default rates, especially some chains of trade schools which were acting as direct lenders in the program, and ultimately it was disbanded in favor of the state guaranty agency-based structure which we have today.

The fact is that many of the issues surrounding direct loans cannot satisfactorily be resolved at this time. No one knows for sure whether the Department of Education will be able to improve upon its past performance, although the Clinton Administration seems intent on doing so. And while the potential for federal savings from direct lending are both real and substantial, no one can be absolutely certain that these savings will materialize until the concept is tried and evaluated.

Developing A Competitive Alternative

To address the various concerns that have been raised about direct lending, the federal government could establish a competition between direct lending and privately financed loans. Such a competition might better serve the needs of both taxpayers and students now and in the future than relying either entirely on the current structure of privately financed loans or shifting totally to the largely untested direct loan concept. Instead, a competition would allow for a reasonable test of these two student loan financing systems.

Under such a competitive arrangement, the Administration's proposal for direct loans (with only slight modifications) would be implemented through 1997.[1] Under the Administration's proposal, the proportion of loans made with federal funds would rise from 4 percent in 1994 to 25 percent in 1995 to 60 percent in 1996, and 100 percent beginning in 1997. Under a competitive approach, the phase-in of direct lending might reach 50 percent by 1996 and continue at that level in 1997. Thus, when the competition was at full tilt, direct loans and privately financed loans would each account for half of the annual federal student loan volume.

As in the Administration's proposal, institutions deemed capable by the Department of Education to act as direct loan originators would be eligible for direct access to federal capital to make loans to their students. Also, under the direct loan component, alternative loan originators would be designated for students attending institutions that do not wish to be, or are deemed incapable by the Department of being, direct loan originators.

Because under the Administration's direct lending proposal roughly half of the new federal student loans made over the next five years will be financed with private capital, it is important to consider what steps might be taken to reduce the profits on these loans as well. The Clinton Administration chose not to reduce the profits on these privately financed loans because lenders might then withdraw from the program before the federal government would be ready to provide the capital for all new loans.

In effect, the Clinton Administration's decision not to change the provisions governing new privately financed loans made over the next five years can be viewed as an attempt to convince the banks not to get out of the student loan business until the federal government is ready to finance all student loans directly.

But the following question still lingers: Why not adopt at least some of the proposals the banks, Sallie Mae, guaranty agencies and others have made to produce savings in these privately financed loans as well? It certainly would be much easier to achieve the more than $4 billion in five-year savings called for in the 1994 budget resolution if those savings were spread over all federal student loans made over the next five years rather than limited only to direct loans. Moreover, some of the additional savings generated from squeezing the profits on privately financed loans could be used to pay for reductions in the cost to borrowers.

A critical element of the competition suggested here would be to use it as a *quid pro quo* to squeeze some profits out of the privately financed student loans made in the future by adopting some of the proposals that have been made by the banks themselves, among others. These profit squeezing measures might include introduction of an auction format, in which lenders would bid for the right to make student loans, and other provisions designed to produce a true market-based rate of return on these loans.

This notion of competition should also extend to the $70 billion of loans already in the pipeline for borrowers who are still in school or in repayment. The best results from a competition occur if it operates in all directions. For example, the government should be able to compete with secondary markets to purchase existing loans from their current holders, just as the private sector organizations will be allowed to compete with the government in the making of new loans.

To test the results of this competition, the Department of Education, the General Accounting Office, and private accounting firms (under contract to the government) would be asked to complete evaluations based on criteria established in legislation regarding cost savings, simplification, and other aspects of these two financing systems by the end of 1997. In 1998, these evaluations could then be debated, and a decision could be made at that time about the future course of events.

Based on these evaluations, federal policy makers might decide at that time that direct lending does indeed work as well as advertised and should be extended for all new loans in the future. Or it might be the case that direct loans do not live up to expectations and that a trimmed-down system of privately financed loans produces sufficient savings and greater efficiency to justify returning to the traditional federal reliance on guaranteed loans. Or perhaps combining the two financing systems, and thus continuing to reap the benefits of competition, would turn out to be policy makers' preference. What is clear is that after several years of experience with both approaches, policy makers would be in a better position then than they are now to decide which approach to adopt for all future new loans.

Reinventing Government

A competitive approach such as the one described here would seem to be much more in the mode of reinventing government than either a totally federally run system of direct loans, or the current loan programs in which the federal government pays the private sector for the use of its money. We have already seen the benefits of greater competition brought about by direct lending this year as banks, guaranty agencies, secondary markets, and others have made cost-saving proposals they previously had rejected because of the new Administration's commitment to direct lending.

Despite their reliance on the private sector as the source of loan capital, the federal student loan programs traditionally have insulated program participants from the effects of market forces. The interest rate, the lenders' rate of return, and most other aspects of the program are set through legislative or regulatory fiat rather than the market. Moving away from this traditional insulation and forcing the private sector to compete with the government should produce market-driven benefits in the form of better service and lower costs.

One form of competition would be to allow the government to pay off existing loans from current holders, in effect transforming these privately financed loans into direct loans. This provision would not only introduce more competition into the pricing and service provided through the secondary markets, it would also allow for a more rapid and more comprehensive evaluation of direct loans.

More competition would be good for the federal government as well. Rather than simply cede student loans to the bureaucracy in five years as under the Administration's direct loan proposal, a competitive approach would place pressure on government officials to perform up to a certain standard; otherwise, the job will be given back to the private sector. It is in this sense that competition in the student loan programs would be more in line with the principles of reinventing government.

Other Suggested Changes in the Administration's Proposal

The Clinton Administration's direct loan proposal holds the promise of bringing much needed changes and substantial savings to a federal student loan structure that is both too costly and too complex. But the Administration's plan falls short of using direct lending as a means to meet the other worthwhile goals of reducing the costs to borrowers, streamlining the student loan structure, and decentralizing program administration through a partnership with the states. These objectives could be met through the following further modifications in the Administration's proposal:

First, the Administration's proposal to reduce the costs to borrowers should be accelerated and expanded. The Administration plan calls for reducing the interest rate charged to borrowers by 1/2 percentage point beginning in 1998 when the direct lending program would be fully implemented. The Administration also proposes to tie the student borrower interest rate in the future to the 10-year Treasury bond rate rather than the 91-day Treasury bill rate, as under current law.

Under the competitive approach suggested here, some of the additional savings generated from squeezing the profits out of the privately financed loans could be used to lower the costs of borrowing to students much sooner than 1998. For example, the rate charged to borrowers might be reduced to Treasury bill plus 2 percent beginning with all loans made in fiscal 1995 (with private sector lenders receiving payments through an auction to provide them with a market-rate of return).

The additional savings gained from reducing the profits in privately made loans might be used to reduce or eliminate the fees currently charged to borrowers. If the guaranty agency reforms mentioned later are adopted, the insurance premium of up to 3 percent now charged to borrowers could be eliminated, and the terms and conditions of direct and privately financed loans could be made identical. In addition, the current 5 percent origination fee could also be eliminated, although my own preference would be to retain this fee and use it to offset federal costs for default or the subsidies that may be entailed in income-contingent repayment.

Second, the current half-dozen federal student loan programs should be consolidated into one student loan program and one parent loan program. A principal motivation for the Clinton campaign proposal for student loans was to simplify what has become an increasingly complex set of programs. One of the most confusing aspects of the current system is the plethora of existing loan programs -- Stafford, an unsubsidized program created in 1992, Supplemental Loans for Students (SLS), PLUS, and Consolidation loans under the Federal Family Education Loan (FFEL) umbrella, as well as Perkins and several health professional loan programs administered by the Department of Health and Human Services.

What the Clinton Administration has proposed, however, is likely to add to this complexity by creating a new set of direct loan programs that mirror each of the existing privately financed FFEL programs. Thus, instead of the more than half dozen programs that now exist, there will be a dozen federal student loan programs for the next five years if the Clinton proposal is adopted.

The debate over direct lending represents a legislative opportunity to rationalize and streamline the student loan structure by moving to a system in which there was one student loan program (with a subsidized and unsubsidized component) and one parent loan program. Students and administrators alike would surely benefit from such a consolidation. Whether a loan is made directly with federal capital or is financed through the private sector should not require separate programs. This call for the consolidation of student loan programs is consistent with suggestions made by the National Commission on Responsibilities for Financing Postsecondary Education and the Advisory Committee on Student Financial Assistance.

Third, the existing guaranty agency structure should be substantially revamped regardless of whether the Administration's direct loan proposal is fully adopted. Under the Administration's direct loan proposal, the existing state or non-profit guaranty agencies would administer the new $50 billion in privately financed loans made over the next five years as well as the $70 billion in loans that are already in the pipeline. A new federal structure, buttressed in large part through a system of contractors, would be created to administer the $50 billion in direct loans that will be made over the next five years. This new federal structure would be responsible for administering all new loans made after 1998.

This dual administrative arrangement seems terribly inefficient as well as contrary to other Clinton administration initiatives. It creates a new administrative apparatus while it leaves in place for the next five to ten years an existing structure which most observers agree is in serious need of reform. It also runs counter to the Clinton philosophy, as seen in National Service among other proposals, that seeks to minimize the growth, or if possible, reduce the size of the federal bureaucracy and to capitalize on the capacities and abilities of the states.

Many of the existing guaranty agencies are already on shaky financial footing under the current structure of reinsurance. The decline in new privately financed loan volume that will result from implementation of direct lending, and the consequent loss in borrower fees that this new volume now generates, are likely to lead many of these agencies to follow the lead of the Higher Education Assistance Foundation, the then largest guarantor that went into federal receivership several years ago.

Yet other of these agencies, especially several which operate as non-profit entities in a number of states, are so strong financially that they now have hired some of the highest-priced lawyers in Washington to represent them in the direct lending debate. Their ability to pay the fees of these lawyers speaks volumes about the need for reform of the existing structure.

Rather than leave the current unwieldy structure alone to wither away as direct lending is phased in, the guaranty agencies instead should be revamped substantially and incorporated as an integral part of the direct lending structure. To achieve this purpose, these organizations should be made into state agencies that will be asked to carry out many of the administrative functions needed for both direct and privately financed loans.

The single most important reform in this regard would be to replace the existing system of sliding scale reinsurance with full federal insurance of defaults. Full federal reinsurance would place all of these agencies on a much sounder financial footing, and at the same time, rein them in to be what they were initially intended to be -- agents of the federal government that could do a better job of monitoring lenders and schools than a much more remote federal government.

To encourage these agencies to be diligent about default prevention, an alternative arrangement could be made in which state agencies that performed well in terms of keeping down defaults and other measures might receive a federal payment for a portion of the savings attributable to that superior performance. By the same token, a poor performance might require states to pay a portion of the costs attributable to that poor performance. This kind of arrangement could make these state organizations partners as well as agents of the federal government.

The existing sliding scale approach, which dates back to the mid-1970s when state participation was encouraged, has been justified as the single form of risk sharing in the program. But it is the borrowers who bear this risk through the fees they pay to the agencies. When these fees are more than sufficient to cover the agency's default exposure, they are used to build reserves which are available for other purposes, including paying for high priced lobbyists and expensive studies designed to undermine direct lending and the consequent loss of profits and revenues.

Making these guaranty agencies into true state agencies could have other advantages as well. It would allow for much greater coordination of federal policies with those of the largest financier of higher education -- the states. For example, these state agencies could then assume the role of coordinating student financial aid policies and delivery from different levels of government and the private sector, a function which is largely absent in the existing student aid structure in this country.

Appendix: Will Direct Loans Save the Federal Government Money?

A number of the groups who profit from the current guaranteed student loan structure not surprisingly have led the charge of describing the savings estimates associated with direct lending as dubious. This appendix explains why there is nothing dubious about the savings from direct loans and reviews several of the studies which have been distributed to dispute these savings estimates.

To understand the debate over the potential for savings from direct loans, it is important first to understand the credit reform rules that were passed as part of the 1990 Budget Enforcement Act. Prior to credit reform, all federal spending for loans was accounted for on a cash and current basis; revenues and spending were recorded on the federal books on the basis of the year in which they occurred.

This traditional federal accounting procedure tended to bias federal decision making in the direction of guaranteed loans since one year's worth of interest payments were the only spending that would show up on the federal books in the year the loan was made. All of the federal payments for interest and potential defaults which that loan would require in the future thus were not shown in the federal budget when the decision was made to make the loan.

By contrast, the capital required to make direct loans appeared in the year it was made under the old accounting rules, while the repayments that would come back to the government from having made that loan would be hidden in future year budgets. This accounting procedure helps to explain why guaranteed loans mushroomed over the past quarter century to become the principal source of college student finance in this country, while Perkins Loans have languished as a relatively small federal aid program.

Credit reform seeks to remove this traditional bias by putting direct loans and guaranteed loans on a more equal budgetary footing. Under credit reform rules, all federal loan costs are accounted for on the basis of the present value of the payments or subsidies that the government provides over the life of the loan. In the case of guaranteed loans, this means that the interest and default payments that occur over the life of the loan are estimated and discounted to a single sum at the time the loan is made. For direct loans, the federal cost under the credit reform rules is the present value of the difference between what the government earns on a direct loan compared to its costs.

It seems fair to say that without credit reform the recent debate over direct loans would not have occurred because the old accounting rules would have always shown direct loans to be more expensive than privately financed student loans. With credit reform, direct loans became a much more attractive option to federal policy makers.

Under credit reform, the federal savings from direct lending accrue in two forms. While a borrower is in school, the savings are the difference between what the government currently pays to borrowers (T-bill plus 3.1 percent for new borrowers) and the government's cost of money (T-bill), times the number of years in school. This comes to about 6 cents per dollar loaned, assuming that borrowers remain in school an average of two years. For the many borrowers who remain in school for more than two years, the potential federal savings from direct loans are much larger.

The other component of federal savings on direct loans comes during the repayment period in that the government in essence will make a profit under direct lending. The amount of these profits/ savings equals the difference between what the borrower repays (T-bill plus 3.1 percent), and the cost to the government of T-bill plus the costs related to servicing (which under any reasonable reimbursement scheme would not exceed two percent of the face value of the loan). Thus, the federal savings during repayment should equal at least one percent of the outstanding value of the loan times the number of years in repayment, again discounted back to present value. This comes to about 4 cents per dollar loaned.

When the federal savings during the in-school period are combined with savings that occur in repayment, the total savings from direct loans thus equal roughly 10 cents per dollar loaned. The total federal costs of guaranteed loans at current interest rate levels are roughly 20 cents per dollar loaned, so that direct loans are estimated to save roughly half of the current costs. The largest remaining cost would be for the federal costs of defaults.

A number of recent studies have disputed these estimates of the federal cost savings from direct loans. The most prominent of these studies was published by the Congressional Research Service in February 1993. Entitled Federal Family Educational Loans: Reduced Costs, Direct Lending, and National Income, this study has been widely distributed and quoted by opponents of direct lending in large part because it argues the direct lending will not save the federal government any money. It also is the case, however, that the basic conclusion of the CRS report agrees with the proponents of direct lending, namely, that there are excess profits in the existing federal student loan programs.

The argument in the CRS paper is based on several curious assumptions and findings. The first curious assumption is that the federal student loan programs provide a competitive rate of return to the banks and others who participate in the program. The history of the federal student loan programs runs directly contrary to this assumption: rather than let the market determine the price, virtually all features of the programs are set through statutory and regulatory provisions. If the terms and conditions in these programs had been set by market forces, it is possible that much of the current controversy over direct loans would not be occurring.

A second assumption underlying the CRS report is that any shift in reliance from the private sector-based current structure to one in which the federal government provides the capital would result in no net increase in national income. That is, in the report's words, "any increased funding available for public spending would be exactly offset by reduced private sector income". While this is most likely true, it is not clear why the fact that national income would not increase should deter policy makers from squeezing excess profits out of the current system to the benefit of the taxpayer or the student. If this criterion of net national income gain were used in the analysis of other public policy issues, many worthwhile reforms would be judged ineffective, including health care reform and federal housing program changes.

The CRS assumption that has received the most discussion is the notion that a squeezed down current structure could produce as much savings as the proposed shift to direct lending. It certainly is the case that some level of reduction in the rate of return on privately financed student loans would equal the savings generated by direct lending. What the CRS report seems to ignore, however, is that the current participants the student loan programs always have resisted changes that would have netted far less in federal budget savings that what could result from direct lending. The banks and others are now coming forward with proposals that would yield substantial savings, but they are only doing so because of the threat presented by direct lending.

A number of private studies, which have been commissioned or conducted by organizations that profit from the current system, not surprisingly suggest that direct lending will not result in the level of federal savings indicated by the Administration and supported by estimates of the General Accounting Office and the Congressional Budget Office. One such study was conducted by Rudolph Penner, former director of the Congressional Budget Office, now an economist with KPMG Peat Marwick. This study was prepared for the Coalition for Student Loan Reform, a misnamed ad hoc group of guaranty agencies and others with a clear stake in maintaining the status quo.

The principal contention of the Penner study is that direct lending will not save the government money because the government's cost of borrowing will increase from the additional debt it will need to incur in order to provide the capital for student loans. But the capital markets for public and private capital have become increasingly homogeneous over time, with the result that interest rate differentials reflect risk variances rather than changes in the mix of public and private debt. There is an active debate now underway about whether increases in government debt lead to a narrowing in the interest rates paid on public and private debt issues, with reputable economists on both sides of this issue.

Moreover, in the absence of direct loans, the government will still need to borrow money to subsidize the banks and others who make privately financed loans. Currently, the federal government borrows about $5 billion a year to make interest and default payments in the current student loan programs. Unlike direct loans, which become self financing once repayments equal the volume of new lending, the borrowing that the government needs to make subsidy payments for privately financed loans are never repaid.

Thus, at some time in the future, the amount the government borrows to finance the payments to lenders of privately financed loans will exceed the amount of borrowing needed to provide the capital for direct loans. The Penner study estimates that the amount of accumulated government borrowing to pay for privately financed loans will exceed the borrowing needed to finance direct loans by the year 2004, although the interest on this accumulated government debt through subsidies paid to private lenders does not appear to be included in the cost analysis. It appears that within ten years of implementing direct loans, even critics agree that the government's need to borrow under direct lending will be less than it would be if the current program were to continue as it is.

Another issue raised by Penner is the current difference between short-term and long-term Treasury rates and the impact it could have on the cost estimates associated with direct lending. Currently there is roughly a two percentage point rate difference between the 91-day Treasury bills and the 10-year Treasury bonds. Penner and others have pointed out that if the 10-year bond rate were used as the estimate of the government's cost of money under direct loans, rather than the 91-day Treasury bill rate, then most of the government's savings would be eaten up by this difference.

This assertion is correct if the Treasury were to use 10-year bonds to finance direct loans and if the difference between short-term and long-term rates remains at two percentage points in the future. But the Treasury would try to avoid such a disadvantageous spread situation just as private lenders do now. Also, two percentage points is a very high differential between short-term and long-term rates by historical standards, and this differential is more likely to narrow than expand over time. With such a narrowing in market interest rates, the cost consequences for direct lending would sharply diminish as well.

Penner in a separate study for the Coalition complains of the difficulty in estimating federal costs under credit reform, pointing particularly to the fact that interest rates will change over time in unpredictable ways. This argument about estimating difficulties is ironic since Penner was supportive of credit reform while at CBO, and most other reputable economists believe that the shift toward credit reform represents a substantial improvement in federal budget procedures.

Another recent study, entitled The Bottom Line, suggests four reasons that no federal savings result from direct loans. Perry Quick, an economist with the national accounting firm of Ernst and Young, directed the study, which was commissioned by USA Funds, a national guarantor and servicer of federal student loans which stands to have sharply diminished revenues under direct lending.

First, the Quick study cites the decline in market interest rates since GAO and CBO did their analysis. But if anything, lower interest rates should lead to greater savings since the discount rate will be lower yet the dollar differential between direct lending and privately financed student loans will remain the same.

Second, Quick asserts that the CBO and GAO cost estimates of servicing and administration in their analysis of direct lending are too low because they use the costs faced by Sallie Mae. But the market-based costs of contracting for servicing now run about $40 per year, which is roughly the figure used by CBO and GAO. Quick also includes a cost of approximately $25 per loan during the in-school period when all the lender has to do is bill the government four times a year for its interest payments. In short, the estimates of servicing costs used in this and other studies seem wildly high, and seem to reflect more the bias of the sponsors than the actual costs of doing business.

How to account for the costs of administration has been a particularly contentious issue in the direct lending debate. The credit reform accounting rules require that administrative costs (including those for servicing) be accounted for on a current year basis, rather than the discounted present value of a stream of payments calculation that is used to estimate other program costs.

CBO, in response to a request by Senator Pell, more recently has indicated that if administrative and servicing costs were included in the calculation of a discounted stream of payments, the five year savings from direct loans would be much lower than previously indicated. Opponents of direct lending will argue that this more recent CBO analysis confirms their longstanding contention that direct lending will not save the federal government nearly as much money as what its proponents have argued.

What this argument over administrative costs most confirms, however, is the importance of focusing on the long term savings from direct loans rather than looking only at the annual savings over the next five years, a figure which can be manipulated in a number of ways by proponents on both sides of the issue. On a long term basis, administrative costs, including paying institutions and others for loan origination, offsets only a small portion of the savings from direct loans. When administrative and servicing costs are subtracted from the savings related to interest rate differentials, the total federal savings from direct loans still amount to about 8 cents per dollar loaned.

A third assumption included in the Quick study is that default costs will increase under direct lending. This may or may not be true, but none of the government's cost estimates for direct lending assume any change in default costs in order to maintain an apples-and-apples comparison between direct and private lending. Nor do the government's estimates of direct loan cost savings include any savings resulting from income-contingent repayment options, again for reasons of keeping the estimates comparable.

The final Quick assumption is the same as that of Penner, namely, that the government's cost of borrowing will increase under direct loans. While this argument has the truest ring of any of the points in the Quick analysis, the realities of current day capital markets mentioned earlier in response to the Penner study raise doubts about the validity of arguing that additional government borrowing increases its cost of capital. As was also mentioned previously, reasonable economists differ on this point. Perhaps the most persuasive argument in this regard is that, in the 1980s, the amount of federal borrowing increased considerably relative to private debt, yet the interest rate differential between public and private debt issues did not narrow appreciably.

ABOUT THE AUTHOR

Arthur M. Hauptman has been an independent consultant since 1981, specializing in issues relating to higher education finance and federal budget policies. Recently, he has written on reforming student-aid programs, the growth in college tuitions and costs, and the financial condition of American higher education. He previously served on the staff of the U.S. House Budget Committee and the U.S. Senate Labor and Human Resources Committee. Hauptman received a B.A. from Swarthmore College and an M.B.A. from Stanford University.